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**Savills World Research**
Shanghai

# Briefing
# **Office sector**

February 2014

Image: Garden Square, Jing'an district

## SUMMARY


New supply toward the end of 2013 resulted in an uptick in vacancy rates, while landlords, especially in Puxi, further adjusted rents downward.

- Three new projects were launched in the fourth quarter, bringing annual supply to 410,757 sq m and total city-wide Grade A office stock to roughly 5.4 million sq m.
- Net take-up totalled 67,244 sq m in the fourth quarter, bringing the net total take-up for 2013 to around 320,472 sq m.
- As a result of the new supply, the city-wide vacancy rate increased by 2.9 percentage points (ppts) quarter-on-quarter (QoQ) to 8.1%, up 1.1 ppts year-on-year (YoY).
- Rents fell by 0.5% in the fourth quarter to an average of RMB8.41 per sq m per day, up 1.1% YoY.
- Nine major en-bloc office transactions were concluded in the fourth quarter, representing a total consideration of RMB18.5 billion.
- Gross reversionary yields remained steady at 5.2% in Q4/2013, although end-user acquisitions continue to be transacted at significantly higher values.


"Soft demand and rising supply levels are expected to result in rising vacancy rates and declining rents in 2014."

James Macdonald, Savills Research

## Market commentary

The influx of new supply in the fourth quarter resulted in a marked increase in vacancy rates towards the end of the year, as the newly completed projects achieved lacklustre pre-commitment rates prior to handover. Uncertain economic conditions continue to restrain demand from tenants who are unsure about future growth prospects, while many also see the potential for better deals in 2014 once a greater number of projects enter the market.

Landlords responded to these conditions by lowering asking rents and allowing for greater negotiation in face rent discounts or extending rent-free periods.

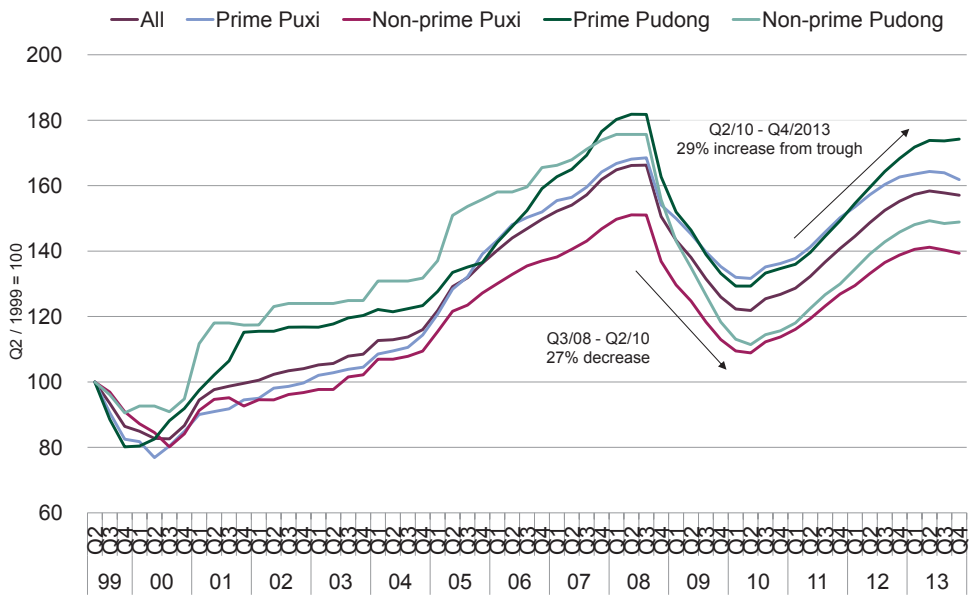
While the economic reforms outlined at the third plenary hearing in Beijing in November and in further announcements with regards to the Shanghai (Pilot) Free Trade Zone (SPFTZ) demonstrate the government's ambition to boost economic and business activity, the tangible benefits of these steps are unlikely to be felt in the office market in the short term until more details emerge.

Grade A office rents fell by 0.5% in the fourth quarter to RMB8.41 per sq m per day, the second consecutive quarter of rental decreases after rents fell by 0.4% in the third quarter. Despite having recorded a decrease in rents of 0.8% since mid-year, the Shanghai Grade A office market remained up 1.1% YoY, after having recorded a 2.0% increase in rents in the first half of the year.

While the overall market continued on its downward trajectory, the Pudong market recorded a slight bounce in the fourth quarter, with rents nudging up 0.3% in both prime and non-prime business districts. Puxi, on the other hand, recorded a 0.9% decrease in rents in the fourth quarter, with prime business districts falling 1.3% compared with a 0.7% decrease in non-prime locations.

GRAPH 1

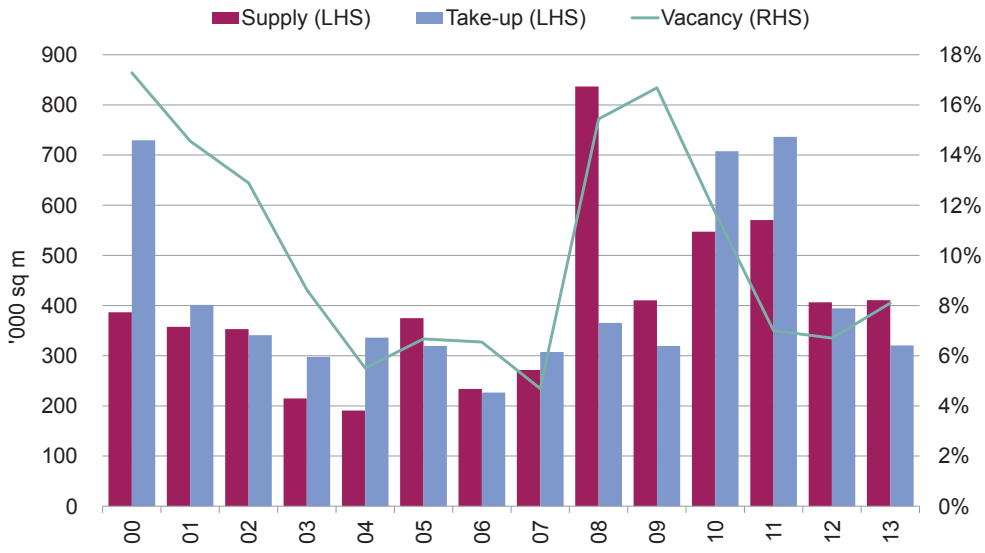
### Grade A office rental indices, Q2/1999–Q4/2013




Source: Savills Research

GRAPH 2

### Grade A office supply, take-up and vacancy, 2000–2013




Source: Savills Research

## Market news

**Three to five fully private banks approved by the CBRC**

The China Banking Regulatory Commission (CBRC) announced that it would be establishing three to five fully privately owned banks in 2014 to channel private capital into the banking sector, which has long been dominated by state-owned players.

In a statement posted on its website, the government regulator said the move will open the country's banking sector to private investors to help boost competition and increase lending to small firms, which are often neglected by the big banks. It likewise promised to maintain "prudential regulatory standards" in approving private banks.

While at the initial stages, the opening up of the banking sector may not only free-up financing to small and medium enterprises starved of capital in recent years, allowing them to restructure debt and invest in expanding business operations, but it may also generate new demand in the office market as these fledgling banks set up business premises in the country's financial centres.

**SPFTZ takes the first steps on the long road of reform.**
While the announcement of the establishment of the SPFTZ was followed by deafening silence and disappointed looks, there are signs that steps are now being taken on the long road of reform that could stimulate growth in key sectors and drive demand for office space in Shanghai.

In late 2013, the People's Bank of China released a six-page report stating that residents in the SPFTZ would be allowed to set up "resident free trade accounts" in both domestic and overseas currencies, and would allow the renminbi to be fully convertible under those accounts "when the time is ripe". Firms within the zone will also be able to borrow money from overseas lenders and use the proceeds outside the zone.

In early 2014, there was a further announcement lifting a 13-year ban on video game consoles. The regulation allows for games consoles to be made within the SPFTZ and sold within China, subject to standard local inspections on multimedia goods.

Three new projects were launched in the fourth quarter adding 234,000 sq m to the market and bringing supply for the year to roughly 410,800 sq m. The addition of the six new Grade A office projects in 2013 brought total city-wide Grade A office stock to roughly 5.4 million sq m.

Net take-up totalled 67,244 sq m in the fourth quarter, bringing yearly take-up to 320,472 sq m, one of the lowest levels seen since the global financial crisis, which reduced take-up volumes in 2009 to just 319,000 sq m.

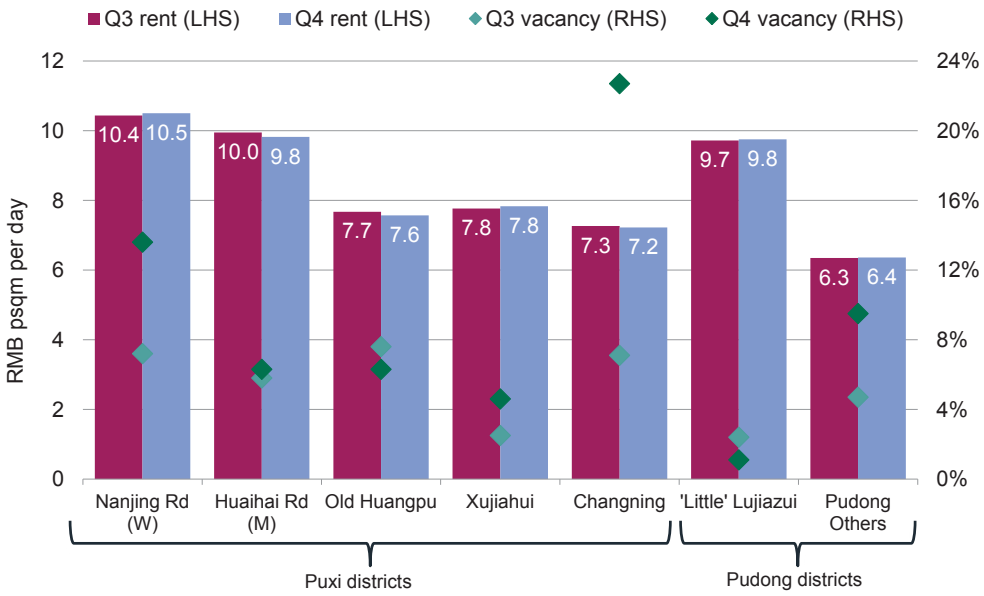
The city-wide vacancy rate increased by 2.9 ppts QoQ to 8.1%. The most evident rises took place in Nanjing Road (W), Changning and Zhuyuan, which all saw the addition of new projects in the fourth quarter. Only Old Huangpu and 'Little' Lujiazui saw decreases in vacancy rates. 'Little' Lujiazui currently has almost no vacant Grade A stock, having seen vacancy rates fall by 1.3 ppts to 1.1%, the lowest level since Q4/2007 when vacancy rates were 0.7% just before the completion of One Lujiazui and Standard Chartered Tower. Meanwhile, Huaihai Road (M) and Xujiahui saw moderate vacancy increases of 0.5 of a ppt and 2.1 ppts respectively.

## Investment market

Despite a slow third quarter in the Shanghai office investment market, the final quarter of the year was very active, with the completion of nine significant deals, representing a total consideration of RMB18.5 billion. Despite weakening fundamentals, significant future supply and low yields, investors still view the office market as one of the most transparent, liquid and deep markets in China, while domestic end users are eager to buy space for self use.

GRAPH 3

### Business district comparison, rent vs vacancy rate, Q3/2013 and Q4/2013




Source: Savills Research

TABLE 1

### Selection of leasing transactions, Q4/2013

| Tenant | Project | Location | Area leased (sq m) |
|---|---|---|---|
| Lear | Baoland Plaza | Yangpu | 8,000 |
| Eisai | Park Place | Jing'an | 4,000 |
| Credit Ease | Raffles City | Huangpu | 2,500 |
| Trafigura Trading | Mirae Asset | Lujiazui | 2,000 |
| Swire | Want Want Building | Jing'an | 1,650 |
| CITIC Trust | IFC 2 | Lujiazui | 1,400 |
| RPS Pharmaceutical | Want Want Building | Jing'an | 1,200 |

Source: Savills Research

TABLE 2

### Selected en-bloc transactions, Q4/2013

| Property | Location | Price (RMB million) | Buyer |
|---|---|---|---|
| Oriental Financial Centre | Lujiazui | 7,000 | Everbright (6%); BoCom (94%) |
| GIFC Phase 1 | Hongqiao | 1,464 | Shenyang Shouyuan |
| China CTS Tower | Putuo | 708 | Van Shung Chong |

Source: Savills Research

The largest deal in the fourth quarter, and indeed in the history of the Chinese real estate market, was concluded in early October when it was announced that Cheung Kong and Hutchinson Whampoa had sold Oriental Financial Centre, an 87,517-sq m Grade A office development in Lujiazui scheduled for completion in mid-2014. The project was sold offshore to China Everbright (6%), HYZL Development (47%) and HYZL Investment (47%). It is widely believed that the Bank of Communications is the true identity behind HYZL Development and HYZL investment.

GIFC Phase 1 was purchased from Gubei Group by Shenyang Shouyuan for RMB1,464 million. The property includes both retail and office components.

Van Shung Chong acquired China CTS Tower from China Travel Service (Holdings) Hong Kong for RMB708 million. The building comprises 31,697 sq m of office and retail space.

Other investment deals included: Caohejing Huaxin Centre, which was bought by an undisclosed buyer; Hongqiao Green Valley was sold to a Taiwanese manufacturer; CITIC Shenhong was acquired by BOCGI; and two office towers in the International Shipping Service Center were sold to domestic end users. There was also the acquisition of a 99% interest in Corporate Avenue 5 by China Life Trustees, which included a call option, similar to a repurchase financing deal.

The strata-title market remained active in the final quarter, with demand primarily coming from domestic end users, given the low yields currently possible from leasing out space in stratified developments. Gross reversionary yields are currently close to 3.5%, just a little bit higher than in the residential market. There may still be a handful of investors active in this sector but they will primarily be looking to generate returns through the appreciation in the value of the property rather than the rental income.

TABLE 3

## Top first-hand strata-title building activity, Q4/2013

| Project | District | Transacted GFA (sq m) | Average price (RMB per sq m) |
|---|---|---|---|
| Oriental Financial Plaza | Pudong | 4,711 | 62,000 |
| Huijing International Plaza | Xuhui | 1,129 | 54,482 |
| North Bund | Hongkou | 5,295 | 53,018 |
| Greenland Hui Zhong Xin | Xuhui | 13,605 | 48,965 |
| Riverside International Plaza | Yangpu | 1,391 | 40,124 |

Source: Savills Research

## Market outlook

Ten new Grade A office projects are scheduled for launch in 2014, potentially adding 668,411 sq m to the market. Puxi will receive seven of these projects, but given the smaller scale of some of these projects, Puxi will only receive 48% of the stock, or roughly 321,000 sq m. Pudong, on the other hand, will receive three projects, but with an average size of 115,000 sq m, they account for a total of 350,000 sq m of Grade A office space.

The Shanghai market found itself at a turning point toward the end of the year, with demand slowing and supply starting to emerge onto the market, pushing vacancy rates up and convincing landlords to lower rental expectations. This trend is likely to gain momentum in 2014 and potentially even through to 2015. Economic growth forecasts, while not as dire as they were at the end of 2008, have deteriorated in recent months after a slight bump in indicators in the third quarter. Most analysts, on average, forecast that economic growth will slow to 7.5% or so, with the most bearish – Societe Generale – looking at 6.9% and the most aggressive – Deutsche Bank – forecasting 8.6%. While the GDP growth rate is no longer the key indicator for many companies, the headline figure does relate a story; one of slower growth in many sectors but especially manufacturing. Slower business growth is likely to follow and consequently weak demand for office space, especially when compared with take-up levels recorded in 2010 and 2011.

At the same time, supply is expected to start increasing, with close to 700,000 sq m forecast in 2014 in core locations and a further 1.3 million sq m scheduled for 2015. This combination of factors will most likely lead to a notable increase in vacancy rates in 2014 and through to 2015. Landlords will respond to rising vacancy rates by offering greater concessions to tenants for the sake of securing occupancy rates and rental income. Current forecasts suggest that vacancy rates will reach close to 10% by the end of 2014 and that rents could fall by roughly 5%.

While this is the current forecast given the information at hand, a number of factors could affect supply and demand and consequently vacancy and rental rates. Developers could, and often do, postpone completion dates due to financial problems, construction delays and approval hold-ups. This would reduce immediate supply and enable vacancy rates to remain at more manageable levels. In terms of demand, government regulations or de-regulations could repress business growth or stimulate expansion, although given the current noise from Beijing it is likely to be the latter. The third plenary session talked about allowing the market to take a more decisive role in the economy, while the SPFTZ has attracted significant interest from financial institutions and other sectors. Additionally, baby steps are starting to be taken down the road of reform and opening up.

There is also the potential for much more significant demand to come from domestic occupiers, either leasing office space, buying strata title or acquiring a whole office tower. Domestic companies and state-owned enterprises account for a significant percent of the occupier market share in Beijing and a number of other cities in China, yet in Shanghai they represent a minority occupier in Grade A office space. As Chinese companies continue to look at opportunities overseas, many may want to establish a presence first in Shanghai. Long thought to be the window into China from the outside world, Shanghai is increasingly becoming a gateway for Chinese companies going overseas. The rapid pace at which Chinese companies are going overseas in recent quarters and the likelihood that they will first build a presence in Shanghai, should be viewed as a significant upside opportunity for the Shanghai office market. ■

# Future project

## Henderson 688

Located in the prime office district of Nanjing Road (W), Henderson 688 comprises 59,744 sq m of Grade A office space as well as a two-storey retail podium. The project is developed by Henderson Land Development and is expected to be handed over to the market in Q1/2014.

The project boasts 1,710-sq m to 3,367-sq m floorplates, a whole-floor efficiency rate of 72% and 145-mm raised floors.

The nearby Nanjing West Station (Metro line 2) can be reached within a five-minute walk, offering transfer-free access to People's Square, 'Little' Lujiazui, as well Pudong and Hongqiao airports.

Current asking rents start from RMB8.0 per sq m per day (US$39.7 per sq m per month) while the management fee is roughly RMB38.0 per sq m per month (US$6.28 per sq m per month).

TABLE 4
**Henderson 688**

| | |
|---|---|
| **Location** | 688 Nanjing Road (W), Jing'an |
| **Owner** | Henderson Land Development Co, Ltd |
| **Handover date** | Q1/2014 |
| **Office GFA** | 59,800 sq m |
| **No. of storeys** | 24 |
| **Floorplate** | 1,700–3,300 sq m |
| **Whole floor efficiency** | 72% |
| **Clear ceiling height** | 2.8 m |
| **Raised floor** | 145 mm |
| **Passenger lifts** | 15 |
| **Car park** | 382 |
| **Asking rent** | RMB8.0 per sq m per day |
| **Management fee** | RMB38 per sq m per month |

Source: Savills Research

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